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Vanessa A. Countryman, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Comment on the Proposed Rule: "Supplemental Information and Reopening of Comment Period for Amendments Regarding the Definition of 'Exchange'"
File Number: S7-02-22

Dear Ms. Countryman,

Thank you for the opportunity to provide feedback on the U.S. Securities and Exchange Commission's supplemental information and the reopened comment period for the proposed amendment to Rule 3b-16 under the Securities Exchange Act of 1934, which pertains to the definition of "exchange." I am writing to express my opposition to the Securities and Exchange Commission's proposed amendments concerning the definition of "exchange" under Section 3(a)(1) of the Securities Exchange Act of 1934, as outlined in Release No. 34-97309.

Objection to the Inclusion of DeFi within the Definition of Exchanges

While I appreciate the SEC's intent to modernize its regulatory framework, the proposal to expand the definition of "exchange" to encompass decentralized finance (DeFi) platforms and certain communication systems is ill-conceived. These platforms and systems operate on fundamentally different principles from traditional exchanges and forcing them into a regulatory framework that does not account for their distinctive characteristics is not reasonable.

DeFi systems, unlike centralized exchanges or markets with order matching engines, do not rely on traditional orders to determine price. Instead, liquidity pools within DeFi trading systems use Automated Market Maker (AMM) protocols, which employ preset mathematical equations—such as the constant product formula (x*y=k)—to balance assets in the pools and determine prices based on trading volumes. This method of price discovery operates continuously and independently of the need to match buyers with sellers. Because trades are executed directly against the liquidity pool, there is no requirement for a direct counterparty. These are crucial distinctions between DeFi and centralized markets, yet the SEC's proposed amendments disregard them entirely. And there are many other differences. More than the purported functional similarities the SEC posits.

1. Incompatibility of Traditional Governance Structures with DeFi

One of the core issues with the proposed rule is the SEC's attempt to equate DeFi governance structures with those of traditional exchanges. This approach overlooks the decentralized and fragmented nature of DeFi governance, which operates without centralized control.

Decentralization and Shared Control Dilution

DeFi platforms are not governed by a single entity or individual. Instead, governance is distributed across a wide array of token holders, liquidity providers, and other participants. This decentralized structure contrasts sharply with traditional exchanges, where control is concentrated in a small group of individuals or a single organization.

Smart Contracts and DAOs as Autonomous Entities

The backbone of any DeFi platform is its smart contracts, which are autonomous and governed by immutable or upgradeable code. Once deployed, these contracts execute preset rules without the need for ongoing human intervention. Many DeFi platforms are further governed by Decentralized Autonomous Organizations (DAOs), where decisions are made collectively by token holders through a democratic voting process. This disperses control across a broad and decentralized community, ensuring that no single party has unilateral power.

The SEC's failure to account for this decentralized governance structure results in a misapplication of the traditional regulatory framework to a system that operates fundamentally differently.

Arbitrary Elevation of Roles

The SEC's approach appears to conflate the various decentralized roles within DeFi platforms with centralized control. This conflation is faulty because it denies the fragmentation of roles involved in DeFi platforms.

While various actors within a DeFi ecosystem—such as developers, liquidity providers, and governance token holders—each play a role in the operation of the platform, none exercises comprehensive control. Developers may create the initial code, but governance decisions may be made by the collective of token holders through votes. Liquidity providers facilitate liquidity, but they do not control the core operations of the platform. Arbitrarily elevating any single actor within this ecosystem oversimplifies how DeFi platforms function and misrepresents the distribution of power. It also imposes a governance regime arbitrarily where there is none. One is led to ask upon what jurisdictional basis the SEC would do this?

Different stakeholders have varying degrees of influence at different times. For instance, governance token holders influence decisions based on their voting power, while liquidity providers affect market liquidity. However, no single party has control over the entire system at any given moment. The SEC's approach to this issue fails to account for the dynamic and decentralized nature of DeFi operations.

Autonomy of Smart Contracts

DeFi platforms operate through smart contracts that function autonomously and non-discretionarily.

Unlike traditional exchanges, where human intermediaries make discretionary decisions about order matching and execution, DeFi platforms rely on automated smart contracts to execute trades. These contracts execute actions based on predefined inputs and conditions without any need for human intervention once deployed. This autonomy further distances DeFi platforms from traditional centralized exchanges.

Immutable Code and Transparency

Smart contracts are often immutable or only changeable through a governance vote, adding an additional layer of decentralization. This stands in contrast to traditional exchanges, where operators can unilaterally alter policies and procedures. The immutability and transparency inherent in DeFi protocols provide operational independence that centralized exchanges lack.

Role of Token Holders and Governance

DeFi governance relies on the collective action of token holders rather than centralized authority. Token holder are participants and not controllers. This is an important feature of DeFi that should not be trivialized. Governance tokens grant their holders the right to vote on proposals, but no individual token holder or group of holders can unilaterally control the platform. Power is diffused across the community, and token holders participate in a shared governance process, rather than exercising control in the traditional sense. In this way, even governance is decentralized.

Governance in DeFi platforms is often decentralized across a global network of participants. The diffusion of power ensures that no single party can control the platform, which makes the SEC's attempt to impose a traditional regulatory framework inappropriate.

Operational Autonomy vs. Exchange Control

The operational autonomy of DeFi platforms, grounded in decentralized blockchain technology, further complicates any attempt to regulate these systems as traditional exchanges.

DeFi platforms are built on public blockchains like Ethereum, where access is permissionless, and smart contracts execute automatically. The decentralized nature of the blockchain infrastructure means that no single entity can restrict access to the platform or control its operations. This decentralization extends far beyond the platform itself and permeates the underlying blockchain, making traditional exchange control paradigms inapplicable.

Traditional exchanges exercise direct control over who can trade, which assets are listed, and how the exchange operates. In contrast, DeFi platforms are permissionless, and access is determined solely by the possession of the appropriate assets or tokens. This reduces the level of control any one party can exert over the marketplace, further complicating the SEC's attempt to apply traditional regulatory measures to these decentralized systems.

2. Impracticality and Harm of Duplicative Trade Reporting

The proposal also imposes duplicative trade reporting obligations on communication systems that are not parties to the transactions they facilitate. These systems act as secure conduits for information flow, not as entities that aggregate buyers and sellers or execute trades. Requiring these systems to report trades would result in unnecessary redundancy and would mislead both regulators and market participants by inflating the perception of liquidity and transaction volume.

Moreover, imposing reporting obligations on communication systems threatens the privacy and security of market participants. These systems are often designed to ensure that vendors have no access to the underlying trade data. Forcing technology providers to obtain and report sensitive trade information simply to comply with duplicative reporting requirements would expose confidential data unnecessarily and alter the relationships between investors and their technology vendors. This would impose significant costs on these systems and create vulnerabilities that do not currently exist.

Conclusion

In addition to the concerns outlined above, I must also emphasize that the principles of due process demand that market participants be given clear notice of what constitutes acceptable and unacceptable behavior under the law. When regulatory bodies enter uncharted territory, as is the case with decentralized finance platforms and other emerging technologies, it is critical that the rules are articulated with precision and transparency.

Historically, stock exchanges began as centralized, physical marketplaces where brokers gathered to trade shares. These exchanges were controlled by a small group of individuals who set the rules, managed listings, and governed the trading process. The New York Stock Exchange (NYSE), for example, evolved from brokers meeting under a buttonwood tree in 1792 into a highly centralized entity that governs trading in a traditional, hierarchical manner. Such centralized governance and control were integral to the structure of early financial markets.

In contrast, decentralized finance operates in a completely different manner. DeFi platforms do not have centralized control or a governing body that dictates how transactions occur. Instead, they function autonomously through smart contracts deployed on public blockchains, where governance is distributed across a broad community of token holders, developers, and liquidity providers. Transactions are facilitated by automated market makers (AMMs) and other decentralized protocols, where price discovery and trade execution are conducted without the need for a centralized intermediary.

The fundamental difference between these two systems highlights why it is inappropriate to regulate DeFi using the same framework that governs traditional exchanges. Applying a one-size-fits-all approach disregards the technological and operational differences between these systems. Just as stock exchanges needed tailored regulation during their early development, so too does DeFi require a regulatory framework that respects its decentralized nature.

Applying the same regulatory framework to a technology whose identifying characteristics do not make it fit into that regime is more than just lazy. The SEC's current approach risks falling into the trap of "Maslow's Hammer"—"I suppose it is tempting, if the only tool you have is a hammer, to treat everything as if it were a nail." In this case, the SEC seems to be treating decentralized finance and other novel technologies as though they fit within the confines of traditional, centralized market structures. This approach ignores the distinctive attributes of decentralized platforms and threatens to undermine the innovation that DeFi represents.

Instead of forcing DeFi platforms into a regulatory framework designed for centralized entities, the SEC should focus on developing a new framework that respects the unique characteristics of decentralized technology. It should take its time in creating such a framework.

Such a framework must also provide a clear roadmap to compliance, offering guidance that is specific to the decentralized and autonomous nature of DeFi platforms. By doing so, the SEC can foster innovation while ensuring that market participants operate within a well-defined and transparent regulatory environment.

There is no shortage of individuals and entities that would register with the SEC when presented with a framework that does not threaten to destroy the technology used. Why not give them a modified regulatory framework that takes the technology into account with a clear roadmap for compliance?

If the SEC intends to hold decentralized platforms or other entities liable for operating outside the bounds of the law, it must provide transparent and comprehensive explanations of the applicable rules and how they will be enforced. Without this clarity, regulatory overreach could stifle innovation, create uncertainty, and unfairly penalize those attempting to navigate an unclear regulatory landscape. Or worse, ensure that the table for regulation by enforcement is set.

Regulation must not only protect investors but also provide a clear path for entities that seek to comply with the law. It is incumbent upon the SEC to provide this guidance, ensuring that market participants are fully aware of the expectations and requirements, particularly as they venture into complex areas like decentralized finance.

Thank you for considering my comments. I look forward to further developments on this matter.

Respectfully,

R Tamara de Silva

De Silva Law Offices

cc. The Hon. Gary Gensler, Chair
The Hon. Hester Peirce, Commissioner
The Hon. Carolina A. Crenshaw, Commissioner
The Hon. Mark T. Uyeda, Commissioner
The Hon. Jaime E. Lizárraga, Commissioner